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Notes on Inflation

One River's Head of Inflation, Lindsay Politi, joins Bilal Hafeez on Episode 214 of Macro Hive.

Here she summarizes the major points of the discussion.

Discussing Higher Inflation Regime, Recession Risks, and Debt Dynamics.

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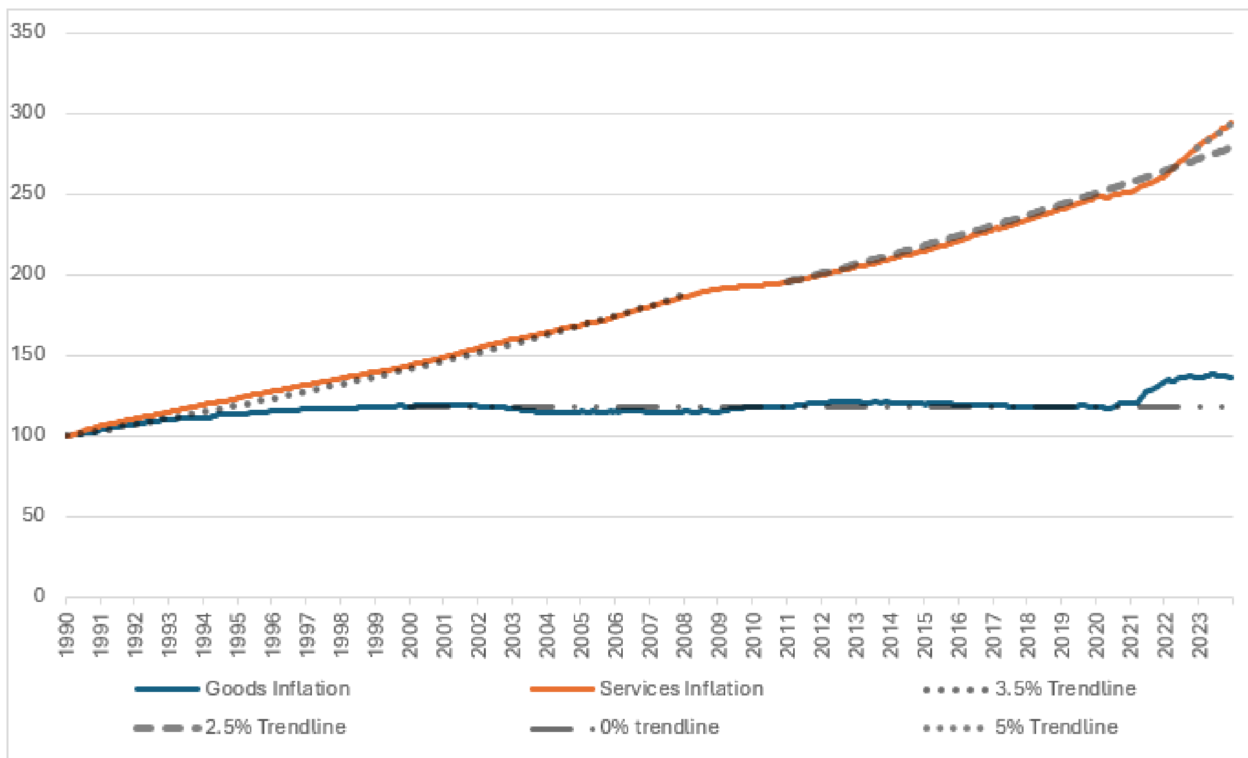
Notes on Inflation

By Lindsay Politi

Head of Inflation Strategies at One River Asset Management

Inflation is Above Target and Not Coming Down.

Despite the hand wringing every month, big picture, inflation, CPI, has been fairly stable for the last year at 4%. Core PCE is maybe a bit lower than that, closer to 3%. But 3% isn't 2%, 2% is the target, and the incoming data make it challenging to continue to say that we're moving to 2%. But the number I keep seeing pop up isn't 2, 3, or 4. It's 5. Supercore inflation is approaching 5%, Atlanta Fed's Sticky Inflation is 5%, and wages are around 5%. Really big picture, since the 1990s the story of US inflation has been: goods price inflation at virtually zero, which pulled down services inflation. Services inflation was 3.5% before the GFC, and 2.5% after the GFC. But it's closer to 5% now. And it doesn't look like the 5% trend is going away. With goods prices already at zero, commodity prices increasing, and ISM manufacturing prices surging, will goods inflation stay around zero? I think the balance of the risks to inflation are probably more balanced than to the downside at this point and the trend we're balancing around could be a lot higher than many people are assuming.



Source: Bureau of Labor Statistics

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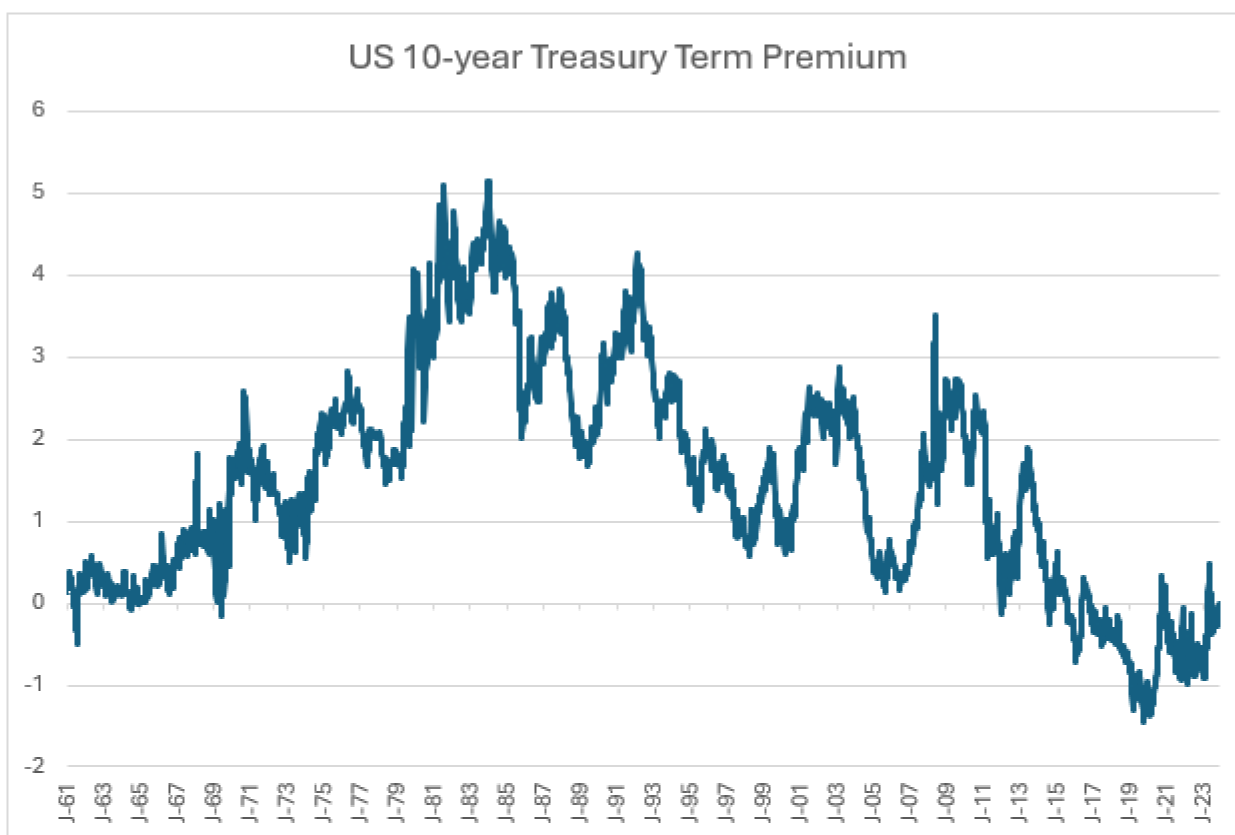
You Should be Compensated for Risk; Not Pay to Take It.

Bond yields are higher but higher yields aren't necessarily cheap. You only need to look at the yield curve to see this. When I see the inverted yield curve I wonder who is paying to take duration risk. I understand the appeal of shorter duration bonds and the return of investment income after more than a decade without it, but giving up yield to get more risk? I don't get it. I can only guess that people are still buying long bonds as a positive carry hedge to their equity portfolios. With yields less than cash I'm not sure it's fair to call it positive carry anymore, but I digress. The rule of thumb that's worked for most investors' entire careers, careers defined by a multi-decade bond bull market and falling inflation, is that adding bonds diversify and hedge your equity portfolio. But bonds aren't a hedge, they're a diversifying investment, and therefore come with their own unique investment risks. Which is to say that bonds are only a hedge to your equities if you completely ignore inflation risk. Yes, bonds do well in a recession, protecting against growth risk in equities, but to diversify away some of your recession risk you're doubling your inflation risk. And doing so at a time when inflation risk compensation, here measured by term premium, is still very low. With this economic backdrop, with inflation risk priced as low as it is, I wonder if the inflation risk lesson from 2022 was learned but not heeded. Have investors really reckoned with the role bonds serve in their portfolio or how expensive duration risk is relative to other ways of hedging equity downside risk? We may not know unless or until we see another upturn in inflation.



Source: Bloomberg

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Currency Risk is More Relevant than CRE Risk

On the podcast I was asked about the risks for the Fed and the bond market from commercial real estate and bank balance sheets. I don't think those risks have gone away, but don't think they're the most immediate risk anymore. The more pressing risk from higher yields is in the currency markets not on bank balance sheets. The yield structure the US needs is diverging from the yield structure the rest of the world wants. The strong dollar is having the effect of exporting US inflation to the rest of the world, an unwelcome development for many countries. The problem here is that the US economy is not particularly sensitive to its own currency, which is especially true now that so much energy is produced domestically. This is in stark contrast to the many other countries who have economies that are very sensitive to their currencies. The magnitude of the slowdown that the US experiences from a higher dollar is less than the impact of higher inflation other countries experience from a weaker currency. The Fed is a domestic central bank, but they are clearly mindful of the tail risks for the US that could circle back from impacts of their policies on the rest of the world. This all means that the hurdle to increase rates is quite high, and 3-4% inflation doesn't come close to clearing that hurdle.

Podcast Link

https://macrohive.com/hive-podcasts/ep-214-lindsay-politi-on-higher-inflation-regime-recession-risks-and-debt-dynamics/

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